Supreme Court, U.S.
FILED
DEC 4 1995
CLERK

No. 95-716

In The

Supreme Court of the United States

October Term, 1995

MARNIE FERNANDEZ, Executrix of the Estate of BEVERLY POSTON and DONALD RUTHERFORD,

Petitioners,

vs.

GEORGE W. EMERSON, JR., Trustee, and RAY MAPLES AND BRENDA MAPLES,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

BRIEF IN OPPOSITION FOR RESPONDENT GEORGE W. EMERSON, JR., TRUSTEE

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QUESTION PRESENTED

1. Are funds fraudulently obtained by the debtor, not held in either an express or a constructive trust, "an interest of the debtor in property" as set out in 11 U.S.C. § 548.

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BRIEF IN OPPOSITION FOR RESPONDENT GEORGE W. EMERSON, JR., TRUSTEE

Respondent, George W. Emerson, Jr., Trustee, respectfully requests that this Court deny the Petition for Writ of Certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in the case of *In Re: Mark Benskin & Company, Inc. (George W. Emerson, Jr., Trustee v. Ray Maples and Brenda Maples, et al.)*, Nos. 94-5421 and 94-5422 (affirmed by unpublished per curiam opinion).

RESTATEMENT OF THE CASE

Mark Benskin established an insurance brokerage and investment commodity business in 1986 known as Mark Benskin & Co. The bankruptcy court found and the parties did not dispute the fact that Mr. Benskin conducted his business as a sole proprietorship and ignored corporate formalities.[1] The main emphasis of the business was investments. Clients invested money with Benskin and hoped to obtain a good return on the investments Benskin promised to make on their behalf. Benskin invested his clients' money in the stock market and in mutual funds. He would then send his clients monthly reports reflecting any gains or losses on their money.

To operate his business, Benskin set up two bank accounts. One account was simply an "operating account" out of which Benskin paid company-related expenses such as rent and electricity. The second account was an "escrow account" into which all client money was deposited and from which all investments were made. Any stocks or securities bought for his clients were paid by transfers made from the escrow account to the brokerage houses, Merrill Lynch and McClarty & Co. Further, any transfers from Benskin to his clients for returns on their investments came out of this escrow account.

In the beginning, Benskin may have actually invested some of the funds as he promised. However, at some point in 1987 Benskin's escrow account became overdrawn due to his personal withdrawals. In Benskin's opinion, he had complete discretion over his clients' money once it was deposited. Furthermore, through false statements, Benskin promised fictitious profits to

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1. Because the corporation did not act as a separate entity the parties and the court referred to Mr. Benskin and Mark Benskin & Co. interchangeably as "Benskin" and treated them the same.

his clients. In order to fund the shortfall, Benskin gradually began to run a classic Ponzi scheme in which old clients were paid their "profits" by using new client's money.

Benskin's client base continued to increase until late 1988/ early 1989. At that time a "run on the bank" started as more clients began demanding larger amounts of money. In an effort to delay the inevitable discovery of his fraud, Benskin paid out all funds in his escrow account in early 1989. However, due to the amount which he had previously disbursed to himself, and the enormous profits he had promised, Benskin's scheme was discovered. Benskin was arrested in April 1989 for mail and securities fraud. Involuntary bankruptcy petitions for Mark Benskin individually, and Mark Benskin and Company, Inc. were filed shortly thereafter. The cases were subsequently consolidated.

After the bankruptcy petitions were filed, the Trustee filed adversary proceedings against all of Benskin's clients who had withdrawn any money within ninety days prior to the filing of bankruptcy and those clients who had withdrawn "*profits*" within the last year prior to the filing. Among the adversary proceedings was the Trustee's fraudulent conveyance action against Brenda and Ray Maples and the fraudulent conveyance action against Donald and Catherine Hollie. Marnie Fernandez and Donald Rutherford intervened in the avoidance actions under the theory that their funds were held by Benskin in trust and, therefore, the money that the Maples and Hollies withdrew should be returned to them and not to the Trustee.

After a trial in each adversary proceeding, the bankruptcy court made the factual findings in each case (1) that Benskin had obtained the funds by fraud; (2) that when Benskin transferred the funds within one year prior to filing bankruptcy, he had the actual intent to hinder, delay or defraud his creditors; (3) that no express trust existed regarding the funds deposited by the intervenors; and

(4) that no constructive trust existed since the trust *res* had been depleted.

The District Court affirmed the bankruptcy court's factual findings and legal conclusions.

On appeal, the Sixth Circuit agreed with the bankruptcy court's decisions and concluded that because such funds were not held in either an express trust or constructive trust at the time bankruptcy was filed, the funds transferred by Benskin were property of the bankruptcy estate. (The Court's opinion is reproduced in the Appendix to the Petition for Certiorari at App. 3(a)-18(a)). In reaching its decision, the court affirmed several factual findings which had been made by the bankruptcy court. First, the court found that the Trustee had proven the elements of 11 U.S.C. § 548(a)(1). The intent to defraud in a Ponzi scheme "is not debatable." *Conroy v. Shott*, 363 F.2d 90, 92 (6th Cir.), *cert. denied*, 385 U.S. 969 (1966). Second, the court found that Benskin did not hold the funds in an express trust. The basis for the court's conclusion was that Benskin did not segregate the funds entrusted to him, Benskin did not treat the property as trust property prior to the bankruptcy filing and there was no identifiable trust *res* since the funds had been depleted from the escrow account prior to the time of the bankruptcy filing. Additionally, the court relied on *In Re Omegas Group, Inc.*, 16 F.3d 1443 (6th Cir. 1994), to find that no constructive trust existed. The court noted that the Intervenors had no pre-petition judgment that impressed the investment funds with a constructive trust in their favor. Thus, the Intervenors had no equitable interest that would exclude the funds from the bankruptcy estate. Based on the above reasoning, the Sixth Circuit affirmed the bankruptcy court's decision in favor of the Trustee.

REASONS FOR DENYING THE WRIT

I.

THE SIXTH CIRCUIT OPINION IS CONSISTENT WITH BANKRUPTCY PRINCIPLES ESTABLISHED BY THE BANKRUPTCY CODE AND PRIOR CASE LAW.

Petitioners argue that the Sixth Circuit decision in this case is inconsistent with prior law because courts have held "that property obtained by the debtor's fraud is not part of the bankruptcy estate" (Petition, p. 12). Petitioners have mischaracterized prior law. The courts have not held property obtained by fraud should be excluded from the bankruptcy estate, but have held that property held *in trust* should be excluded from the bankruptcy estate. *Cunningham v. Brown*, 265 U.S. 1 (1924); *In Re M&L Business Mach. Co., Inc.*, 59 F.3d 1078 (10th Cir. 1995). In the case at bar the Sixth Circuit agreed with the theory that property held in trust is not property of the debtor. But, because the court found that the funds at issue were not held in either an express trust or constructive trust, the court held that the funds were property of the bankruptcy estate. Such a finding is consistent with prior law.

The first case which addressed similar issues involving fraud in the bankruptcy context was *Cunningham v. Brown*, 265 U.S. 1 (1924). In *Cunningham*, Charles Ponzi borrowed money from later investors to pay large returns to earlier investors. The defendants in the case obtained payment shortly before Ponzi's bankruptcy petition was filed. The Trustee argued and this Court found that the payments were preferences. *Cunningham*, 265 U.S. at 11-13. The court found that the debtor had a defeasible title to the money he had recovered and that the funds were "money in the estate of the bankrupt." *Cunningham*, 265 U.S. at 11. Both conclusions are consistent with the Sixth Circuit decision in this case.

Another significant aspect of the *Cunningham* decision was that the debtor's funds had been depleted at the time bankruptcy was filed. This Court found that a constructive trust could not exist without an identifiable trust *res* and that the claimants could not trace their money beyond the commingled fund where the fund was too small to satisfy the claims of similarly situated parties. To allow such tracing would be "carrying the fiction [of tracing] to a fantastic conclusion." *Cunningham*, 265 U.S. at 13. Thus, even if the funds could be physically "traced" by use of a fictional accounting method, the court will not allow such tracing to be done once the fund becomes too small to compensate all of the defrauded creditors.

In this case the Sixth Circuit found that no constructive trust existed because there was no identifiable trust *res* and because the funds had not been impressed with a constructive trust by a prior judicial determination. Many prior decisions (including a decision by the Sixth Circuit) have held that an identifiable trust *res* is mandatory for the finding of a constructive trust and that such trust *res* cannot be traced through a commingled fund after the account reaches an amount lower than the deposit. *First Federal v. Barrow*, 878 F.2d 912 (6th Cir. 1989); *In Re Mahan & Rowsey, Inc.*, 817 F.2d 682 (10th Cir. 1987); *In Re Teltronics, Ltd.*, 649 F.2d 1236 (7th Cir. 1981) (both cases are cited by the petitioners).

In *First Federal*, the Sixth Circuit set forth the rule as follows:

> The situation frequently occurs where trust funds have been traced into a general bank account of the debtor. The following general principles have been applied. The bankruptcy court will follow the trust fund and decree restitution where the amount of the deposit has at all times since the intermingling of

> funds equalled or exceeded the amount of the trust fund. But where, after the appropriation and mingling, all of the monies are withdrawn, the equity of the *cestui* is lost, although monies from other sources are subsequently deposited in the same account. In the intermediate case, where the account is reduced to a smaller sum than the trust fund, the latter must be regarded as dissipated, except as to the balance, and funds subsequently added from other sources cannot be subject to the equitable claim of the *cestui que trust*. If new money is deposited before the balance is reduced, the reduction should be considered to be from the new money and not from the monies held in trust. This analysis may be referred to as the lowest intermediate balance test.

First Federal, 878 F.2d at 916, *quoting* 4 L. King *Collier on Bankruptcy*, Sections 541.13, 541.79 to 541.80 (15th Ed. 1988). Under the lowest intermediate balance test, the funds may only be traced to the extent the account has a balance equal to the trust funds. If the account is reduced to an amount lower than the trust funds, the latter is considered to be dissipated. *First Federal*, 878 F.2d at 916. Once the funds were withdrawn from Benskin's account and paid to others, the trust *res* was lost. Therefore, the decision by the Sixth Circuit in this case was consistent with the prior case law.

Recently the Tenth Circuit upheld the principle that a creditor must trace his funds in order to argue the existence of a constructive trust. *In Re M & L Business Mach. Co., Inc.*, 59 F.3d 1078 (10th Cir. 1995). The court also found that although it is generally proper to return property to a defrauded party rather than

distribute it through the estate to all creditors (including those that had not been defrauded), there is no such distinguishing characteristic which promotes the interest of one over the other in a Ponzi scheme where creditors are almost exclusively defrauded parties. In such situations, it is to the detriment of all other similarly situated creditors to favor one defrauded party over another. *M & L Business Mach.*, 59 F.3d at 1081-82. Such a conclusion is consistent with prior court rulings that a party will not be able to trace his funds through a commingled account which has a zero balance since the result of tracing would favor one defrauded party over another.

Petitioners argue that Tennessee has adopted the first-in/first-out (FIFO) method of tracing funds. However, such method has not been adopted in the bankruptcy context when all creditors have been defrauded and the account balance has reached zero. In *In Re Walter J. Schmidt & Co.*, 298 F. 314, 316 (D.N.Y. 1924) Justice Learned Hand gave the following opinion regarding the FIFO rule, which was also known then as the Rule in Clayton's case:

> The rule in Clayton's case is to allocate the payments upon an account. Some rule had to be adopted, and though any presumption of intent was a fiction, priority and time was the most natural basis of allegation. It has no relevancy whatever to a case like this. Here two people are jointly interested in a fund held for them by a common trustee. There is no reason of law or justice why his depredations upon the funds should not be borne equally between them. To throw all the loss upon one, through the mere chance of his being earlier in time, is irrational and arbitrary and is equally a fiction as the rule in Clayton's case, *supra*.

> When the law adopts a fiction, it is, or at least it should be, for some purpose of justice. To adopt it here is to apportion a common misfortune through a test which has no relation whatever to the justice of the case.

Schmidt, 298 F. at 316.[2] In the case at bar the Sixth Circuit followed overwhelming precedent in order to reject FIFO and to hold that there was no identifiable trust *res*.

In their brief, petitioners rely on several cases which are distinguishable from this case because they involve funds which are statutory "trust funds." For instance, petitioners rely heavily on *Begier v. I.R.S.*, 496 U.S. 53 (1990). However, *Begier* involved "trust fund" taxes established by 26 U.S.C. § 4291, and 26 U.S.C. § 3402(a)(1). Also, 26 U.S.C. § 7501 provided that such withholding taxes and FICA taxes "shall be held to be a special fund in trust for the United States." *Begier*, 496 U.S. at 62. The court found that because of the underlying statutory language, a trust was created at the moment the money was withheld by the employer. Thus, unlike a common law trust in which particular property is the trust *res*, § 7501 creates a trust in the abstract. The court noted, "[c]ommon law tracing rules, designed for a system in which particular property is identified as the trust *res*, are thus unhelpful in this special context." *Begier*, 496 U.S. 62-63. For this reason, the court's decision regarding withheld funds was unique to the statutory scenario.

The same difference existed in the cases of *In Re Joliet-Will County Community Action Agency*, 847 F.2d 430 (7th Cir. 1988) and *In Re California Trade Technical Schools, Inc.*, 923 F.2d 641

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2. *See also, In Re Teltronics, Ltd*, 649 F.2d 1236 (7th Cir. 1981) (relied upon by the petitioners). In *Teltronics*, the court found that the tracing rules should not apply if abandoning the rules would result in equal treatment of defrauded creditors. *Teltronics*, 649 F.2d at 1240-41.

(9th Cir. 1991). *Joliet-Will* involved federal grant money used by a non-profit community service organization. The court found that the nature of the grantor/grantee relationship was unique in that the grantee was an agent to carry out a specific task rather than an entrepreneur using invested funds. *Joliet-Will*, 847 F.2d at 432. *California Trade* involved funds held in an *express trust* pursuant to Title IV of the Higher Education Act of 1965, 20 U.S.C. § 1070-98 (1982). The court recognized that tracing principles used in an express trust relationship with regard to funds kept in a separate trust account do not apply to situations "in which the would-be beneficiary seeks to impress a constructive trust upon currently commingled property of the debtor." *California Trade*, 923 F.2d at 647.

In this case, the Sixth Circuit's decision was consistent with prior law. The court affirmed the bankruptcy court's finding that no express trust existed. The court also held that a constructive trust did not exist because there was no identifiable trust *res* and because a trust had not been impressed upon the funds prior to the filing of bankruptcy. Since there was no trust, the investors had no equitable interest in the funds which would exclude them from the bankruptcy estate. The prior law cited by the petitioners does not require a different result. Funds held in trust are not part of the bankruptcy estate. The funds in dispute in this case were simply not trust funds.

II.

THE SIXTH CIRCUIT OPINION IS CONSISTENT WITH TENNESSEE LAW.

Petitioners argue that the Sixth Circuit erred in finding that under Tennessee law Benskin's acquisition of the funds was "fraud" instead of "theft." The distinction is important since the debtor can obtain a defeasible or voidable title to goods obtained

by fraud, but only a void title as to goods obtained by theft. The Sixth Circuit relied on the Tennessee statutory definition of fraud and theft to find that with theft the owner has no intention to part with his property, but in the case of fraud the owner willingly entrusts his property into the hands of another for such purpose, unaware he is being deceived. Although petitioners argue that there is no difference between fraud and theft, the very case they rely on compared the fact that a bona fide purchaser can acquire good title from a transferee who obtained goods by fraud, but not from one who obtained goods by theft. *Butler v. Buick Motor Co.*, 813 S.W. 2d 454, 457-58 (Tenn. Ct. App. 1991), *cert. denied*, 112 Sup. Ct. 307.[3] In *Butler*, the court held that because a General Motors employee obtained several automobiles by *theft* and not by *fraud*, a bona fide purchaser could not get good title. *Butler*, 813 S.W. 2d at 458. In this case, Benskin obtained the funds by fraud since the investors initially intended to give him their funds for him to invest.

The distinction between fraud and theft has been established by three prior cases. In *In Re International Loan Network, Inc.*, 160 B.R. 1 (Bkrtcy D.C. 1993) the bankruptcy court in the District of Columbia acknowledged the difference between theft and fraud. In *International Loan*, the debtor ran a Ponzi scheme and the Trustee brought 18 adversary proceedings to recover fraudulent transfers. Like the Intervenor in this case, the defendants asserted that the debtor had no interest in the property on the grounds that one who obtains money by fraud obtains no title. *International Loan*, 160 B.R. at 11. First, the court recognized that an agreement induced by fraud is merely *voidable*, not void. Thus, the person defrauded (the defendants)

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3. This same distinction was also recognized in *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995). In *Scholes* the court recognized that a thief cannot pass good title, but "most frauds can." *Scholes*, 56 F.3d at 759. *Scholes* (which was relied upon by the petitioners) decided completely different issues involving a Receivership and the Illinois Fraudulent Conveyance Statute and did not address any of the issues involved in this case.

may affirm the contract and sue for damages, or may rescind the contract. However, the contract is valid until it is disavowed. As long as the victims did nothing to avoid the transaction with the debtor prior to bankruptcy, they had affirmed it. Thus, while such defrauded creditors have a claim against the debtor, that claim does not vest them with title to the property with which they have parted. In the meantime, the debtor has a legally recognized interest in the property, a defeasible title. *International Loan*, 160 B.R. at 11. The Court found this interest successfully met the requirement of § 548.

In *In Re Independent Clearing House Co.*, 77 B.R. 843 (D. Utah 1987) the court also reached the same conclusion:

> [W]hen a debtor obtains money by fraud and mingles it with other money so as to preclude any tracing and when the defrauded party does not timely avoid the transaction but accepts benefits under his contract with the debtor, the money is "property" of the debtor within the meaning of sections 547 and 548 of the Code.

Independent, 77 B.R. at 854. The *Independent* court relied on the holding in *In Re Southern Indus. Banking Corp.*, 66 B.R. 349 (Bankr. E.D. Tenn. 1986) in which the bankruptcy court held that if creditors are all victims of the debtor's fraud and their money has been commingled with other investors' money, they cannot claim that the money they received from the debtor before bankruptcy was not the debtor's money. *Southern Industrial*, 66 B.R. 363-64. The same finding should also apply to the creditors who invested on the eve of the Ponzi scheme in this case. The debtor obtained an interest in the property at the time the investor turned his or her funds over to Benskin.

Lastly, the same distinction between fraud and theft was discussed in *In Re Universal Clearing House Co.*, 62 B.R. 118 (D. Utah 1986):

> There is a very obvious distinction between the cases of goods obtained by felony and fraud . . . ; in the one case, the owner of the goods has no intention to part with his property; in the other he has. A contract for the sale of goods, though obtained by fraud, is perfectly good, if the party defrauded thinks fit to ratify it.

Universal, 62 B.R. at 124. The difference is exemplified in the principle that one who steals funds cannot pass good title even to a bona fide purchaser, but one who obtains property by fraud can transfer good title. Thus, the one who obtains property by fraud must have some legally recognized interest in the property.

In this case, Benskin obtained the Intervenors' money by fraud. Benskin falsely told them that he would invest their money, when he had no such intention. Based on his statement, the Intervenors voluntarily surrendered their funds to Benskin. At that time Benskin obtained an interest in the property sufficient to meet the requirements of § 548.

Petitioners argue that the distinction between theft and fraud is irrelevant because the trustee is not a bona fide purchaser. However, the Bankruptcy Code provides, pursuant to 11 U.S.C. § 548, that the trustee *can recover such property transferred if (1) the transfer involved "an interest of the debtor in property;" and (2) the debtor had the actual intent to defraud.* Petitioners do not argue with the court's finding that Benskin had the requisite intent. Case law provides that property obtained by fraud includes an interest of the debtor in property. Thus, the Sixth Circuit's conclusion is correct and is consistent with Tennessee law.

III.

THE SIXTH CIRCUIT OPINION IS CONSISTENT WITH PRIOR RULINGS OF THE SIXTH CIRCUIT.

Petitioners do not take issue with the recent opinion of *In Re Omegas Group, Inc.*, 16 F.3d 1443 (6th Cir. 1994), but attempt to distinguish it. In *Omegas*, the Sixth Circuit held that unless a court had already impressed a constructive trust upon certain assets or the legislature had created a specific statutory trust, the claimant cannot argue that he is a beneficiary of a constructive trust held by the debtor in bankruptcy. *Omegas*, 16 F.3d at 1447. In the case at bar the Sixth Circuit found *Omegas* to be dispositive of the Intervenor's claims. Based on *Omegas*, the court held that the Intervenors' argument that the transferred funds were held in a constructive trust must fail because a constructive trust had not been impressed on the funds prior to the filing of bankruptcy.

Petitioners argue that distinctions exist between this case and the *Omegas* case, but any differences are meaningless to an analysis. Both cases involve a fiduciary relationship between the debtor and creditor and both cases involve funds that have not been judicially impressed with a constructive trust prior to the filing of the bankruptcy. Although in this case the funds were held by third parties and not by the debtor, a trust does not begin to exist once the funds are transferred into the hands of third parties if the trust was not established when the funds were held by the debtor. The transfer, itself, does not change the character of the funds. Additionally, since only the Trustee has the avoidance power, it does not matter if the debtor or innocent third parties have actual possession of the funds. Once the court determines a constructive trust does not exist, the bankruptcy court gives only the Trustee a right to those funds.

The result in this case is also consistent with the

aforementioned case of *First Federal v. Barrow*, 878 F.2d 912 (6th Cir. 1989). In *First Federal*, the debtor corporation was in the business of coordinating loans between interested property owners and available lenders, to be serviced by the debtor for a fee. When the debtor's cash flow became critical, the debtor began commingling all funds into one account. *First Federal*, 878 F.2d at 914. During the ninety days before filling bankruptcy, the debtor transferred certain funds to certain favored investors, which the trustee attempted to avoid after the bankruptcy was filed. Seven investors argued that the funds were held in constructive trust and, thus, did not constitute property of the estate. The Sixth Circuit found that a trust did not exist because there were no identifiable trust assets. Under the lowest intermediate balance test, no funds could be transferred through the account since the balance was less than the trust fund amount. *First Federal*, 878 F.2d at 915-16. *First Federal* is consistent with the result the Sixth Circuit reached in this case. Only if a constructive trust has been impressed on specific traceable funds can such funds be excluded from the bankruptcy estate.

Petitioners' reliance on *In Re Baker & Getty Fin. Serv., Inc.*, 974 F.2d 712 (6th Cir. 1992), does not demonstrate a deviation by the Sixth Circuit in this case from a prior decision. In *Baker*, an agent was asked by his principal to apply a cashier's check to a corporate loan. The bank directed the agent to deposit the funds in his account until his check cleared. The check cleared and the funds were turned over to the bank. Based on these facts, the court found the bank to be an initial transferee as defined under 11 U.S.C. § 550 because the funds never belonged to the agent. *Baker*, 974 F.2d at 722. The issue was not whether the funds constituted property of the estate, and the court's conclusions have no significance to this case. There is no question that Benskin should not have used the funds for his own purposes. However, limitations on his use of the funds does not mean that Benskin did not have *some* interest in the funds which made them property of the estate.

Lastly, this case does not conflict with *In Re Montgomery*, 983 F.2d 1389 (6th Cir. 1993). In *Montgomery*, the issue was whether funds obtained by kiting checks between several banks constituted an interest of the debtor in property. *Montgomery*, 983 F.2d at 1393. The court found that if *segregated funds impressed with a constructive trust* had been returned to the banks within ninety days prior to bankruptcy, the transfer would not have been a voidable preference because it would not have been the defendant's money that was being transferred. *Montgomery*, 983 F.2d at 1393. However, because there was no contention that the debtor preserved the separate identity of the funds and no contention of any express or constructive trust, the court did not have to decide such an issue. *Montgomery*, 983 F.2d at 1393. The *Montgomery* opinion was not contrary to the result in this case. Funds are not property of the bankruptcy estate if they are held in a constructive trust. The Sixth Circuit simply failed to find that a trust existed over the funds in this case.

CONCLUSION

The Sixth Circuit decision in this case was consistent with the bankruptcy principles established by prior case law, was consistent with Tennessee law and was consistent with prior decisions of the Circuit. Further, there are no other special or important reasons for reviewing this case. Therefore, the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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